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Growing Pains for EM Corporates Amid China's Regulatory Crackdown

BARINGS INSIGHTS

Chinese corporates are experiencing growing pains as fines and restrictions rain down on sectors like tech, real estate and education—but select opportunities are emerging as well.

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Over the past year, the Chinese government has embarked on a campaign to break up monopolies and curb price pressures through new regulations and fines on a number of sectors. Following these announcements, stock prices plummeted and credit spreads widened significantly. However, while the current crackdown is certainly causing growing pains for Chinese corporates, we can see a path forward, toward the much overdue reforms in various parts of the Chinese economy.

For investors trying to contextualize the longer-term market impact of these developments, history does offer some guidance. Looking back at similar crackdown episodes in the past, we note that the Chinese government did eventually ease restrictions to avoid stifling wider economic growth momentum, and for the majority of those past episodes, the market's initial negative reaction created buying opportunities for long-term investors.

A Recap of the Idiosyncratic (Or Not So Idiosyncratic) Crackdowns

One could be forgiven for thinking the various recent government crackdowns are idiosyncratic in nature—taking the real estate sector in isolation, then the tech sector, and finally the consumer and education sectors. However, to us, trends are apparent in the wake of the chaos when viewed through a reform-minded lens.

REAL ESTATE: "HOUSES ARE FOR LIVING, NOT FOR SPECULATING"

In the midst of the post-pandemic economic recovery, the government seems intent on ensuring that housing prices remain affordable and in line with the rhetoric, "houses are for living, not for speculating".[1] In an attempt to prevent prices from rising too quickly and to maintain affordability, the government has continued with a tightening policy bias on the real estate sector. This has involved not only credit tightening via mortgages and construction loans, but also curbs on pre-sale permits for developers, a tightening of rules around home buyer qualifications and mandated balance sheet deleveraging through what is known as the "Three Red Lines."[2]

While these measures do create short-term growing pains for the thousands of real estate developers in China, we view this as a positive for the longer-term investors in the sector—as the crackdown should result in the strongest developers acting as consolidators in the sector and capital being allocated more efficiently.

1. As first mentioned by President Xi Jinping at the 19th National Congress of the Communist Party of China in 2017.
2. (1) Liability-to-asset ratio (excluding advance receipts) of less than 70%; (2) Net gearing ratio of less than 100%; (3) Cash-to-short-term debt ratio of more than 1x. If the developers fail to meet one, two or all of the 'three red lines', regulators would then place limits on the extent to which they can grow debt.

> *"Trends are apparent in the wake of the chaos when viewed through a reform-minded lens."*

TECHNOLOGY: BREAKING UP MONOPOLIES TO FOSTER COMPETITION AND CURB PRICE PRESSURES

In late 2020, the market watched in shock as Chinese regulators stopped an initial public offering (IPO) of ANT Group at the last minute. Subsequently, in early 2021, the government's anti-monopoly regulator imposed a $2.75 billion fine on Alibaba for anti-competitive behavior. In July 2021, regulators blocked Tencent's proposed merger of the country's top two videogame streaming sites, on antitrust grounds. Any day now, the government is expected to formally announce a $1 billion fine on the food delivery app Meituan for anti-competitive practices regulators considered detrimental to restaurants and the app's rival services. And very recently, new restrictions have been announced that are intended to curb the hours of video game play by children under the age of 18.

All of these developments have raised concerns about the future of the technology sector in China, particularly whether the regulations will stifle innovation. However, once again, we would view this through a longer-term lens. While the ad hoc crackdowns and fines have resulted in market volatility, we believe that breaking up the monopolistic grasp of the tech giants is an important step toward fostering new startups, creating an environment for competition to thrive, and improving the efficient allocation of capital—which could ultimately lead to lower prices of goods and services, and thus affordability. One could also consider whether there is a less altruistic reason for the tech crackdown, such as a desire to neutralize some of the power and sway that tech titans have gained in recent years.

DATA AND CONSUMER PRIVACY: THE FIGHT FOR BIG DATA

Data is the new oil, and in China, this is no exception. The recent crackdown on several consumer apps has highlighted the battle over Big Data. For instance, investors watched in bafflement as the Chinese government recently cracked down on the largest ride-hailing company, DiDi, after its New York IPO, by suspending the company's ability to sign on new customers and removing it from China's app stores. Regulators accused the firm of cybersecurity breaches and improper use of consumers' data—suggesting the government's ongoing concern that sensitive data about Chinese consumers might be stored on servers outside of China. We have seen similar actions taken against other consumer-based apps, particularly in the health care and food service sectors, which also hold sensitive consumer data. Beyond the cybersecurity issues, the government is also trying to establish better labor standards for the gig/contract workers that app-based companies employ, to ensure that they earn a minimum wage and have access to health care. Once again, when viewed through a long-term lens, this is in line with the government pledge to encourage high-income groups and enterprises to give back to society more, grow the earnings of low-income groups and promote social fairness, justice and common prosperity.

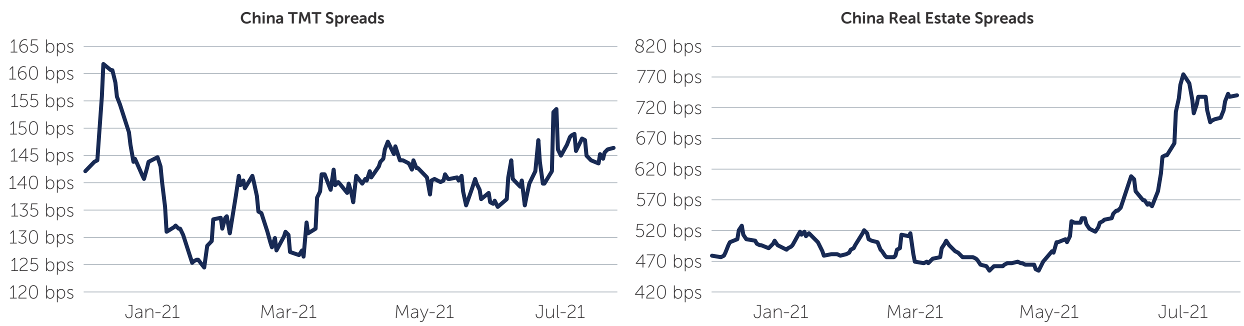
EDUCATION: SHOWING PRIVATE CAPITAL THE "EXIT"

The most recent sector in the cross hairs of the Chinese government is the private, after-school tutoring and test-prep coaching industry, which has grown into a $100 billion industry in China. The government has announced a ban on companies that offer these educational services from making profits, raising capital or going public. Following the announcement, the prices of the country's biggest education sector stocks and bonds—Bright Scholar Education, New Oriental Education & Technology Group—dropped precipitously. However, once again, despite the short-term pain for investors, the government's action could be interpreted as a bid to level the playing field and improve social equality and affordability of basic needs, such as education. The less altruistic view of the crackdown in this sector would be the Chinese government possibly seeking to limit Western-based ideologies permeating the Chinese educational curriculum.

Sifting Through the Chaos, Fundamentals Remain Strong

The reaction in the debt market to the regulatory moves was significant, with credit spreads widening to a similar magnitude as they did in March 2020. Much of the widening came mid-summer in response to the flurry of regulatory measures, with the extent of the widening varying by sector.

FIGURE 1: Spreads Across China's TMT and Real Estate Sectors



SOURCE: Bloomberg, J.P. Morgan. As of August 23, 2021.

Despite the severe market volatility recently witnessed, generally speaking, Chinese corporate fundamentals remain strong. In the tech sector, for example, many of the companies impacted are investment-grade rated, with strong balance sheets, high net cash positions and low amounts of debt—which will provide some cushion against the fines imposed by regulators. Therefore, while the size of some of the regulatory fines have made for attention-grabbing headlines, the credit spread widening could be viewed as a buying opportunity.

IS CONTAGION RISK A THREAT DESPITE STRONG FUNDAMENTALS?

In the midst of the government crackdown, there has also been an unravelling of the historical "moral hazard" notion among Chinese corporate debt investors.

- Huarong, a 100% state-owned asset management company, faced a liquidity crunch that created uncertainty among investors as to whether the government would step in to prevent a default. As a result, spreads widened across the Chinese financial services sector in contagion. While the recent announcement of a potential capital injection into the company provided some respite to the market volatility, we do not view this as a traditional bailout and would watch for the dust to settle on the details. Ultimately, however, we do believe Beijing will try to strike a balance between supporting the reputation of an important financial institution and advancing the deleveraging initiative that is critical to the country's long-term future.
- Developer Evergrande has also struggled with liquidity problems. As a result, the company has seen its bond spreads widen significantly, which caused some contagion to China's real estate sector more broadly. However, while real estate is more vulnerable to contagion risk because it is highly leveraged and requires constant liquidity, past bouts of correction have often proved to be buying opportunities—particularly for long-term investors with the ability to identify companies with solid fundamentals.

At a high level, while these regulatory actions have certainly created volatility and uncertainty across the market, we believe they stem from the government's desire to strengthen economic and social stability—and we do not believe the government's actions will stifle innovation. That said, for certain sectors, like education, the changes will greatly affect the ability of companies to attract investors, as firms are being forced to change their business model and shift to a non-profit status. For other sectors, however, the severe restrictions that have been imposed over the past year could bring long-term benefits. In the real estate sector, for instance, companies that can endure the changes could emerge with stronger balance sheets. And for the tech sector, increased competition and the breakup of monopolies could bring fairer prices for consumers and better protections for workers.

Key Takeaway

Regulatory risk is an ongoing concern that must be carefully monitored and evaluated when investing in emerging markets. As we closely monitor the direction of regulatory policy in China, acknowledging the many risks that exist across the landscape, we expect opportunities to emerge as well. However, particularly in times of heightened uncertainty, bottom-up, fundamental credit analysis plays a critical role—not only in uncovering companies with solid fundamentals that should prove defensive in times of market turmoil, but also in navigating risks that a change in the regulatory environment can create.

At Barings, we have the breadth and resources to examine the business of each issuer and assess the robustness of that business model against the macro and regulatory backdrops. Given the ambiguity around some of the data coming out of China, we also conduct our own due diligence as part of our bottom-up, fundamental analysis.

For more on this topic, please listen to this recent episode of Barings' Streaming Income podcast, with author, and Head of Emerging Markets Corporate Debt, Omotunde Lawal.*

*Full Podcast URL: https://www.barings.com/us/guest/viewpoints/em-debt-assessing-the-impact-of-china-s-crackdowns

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